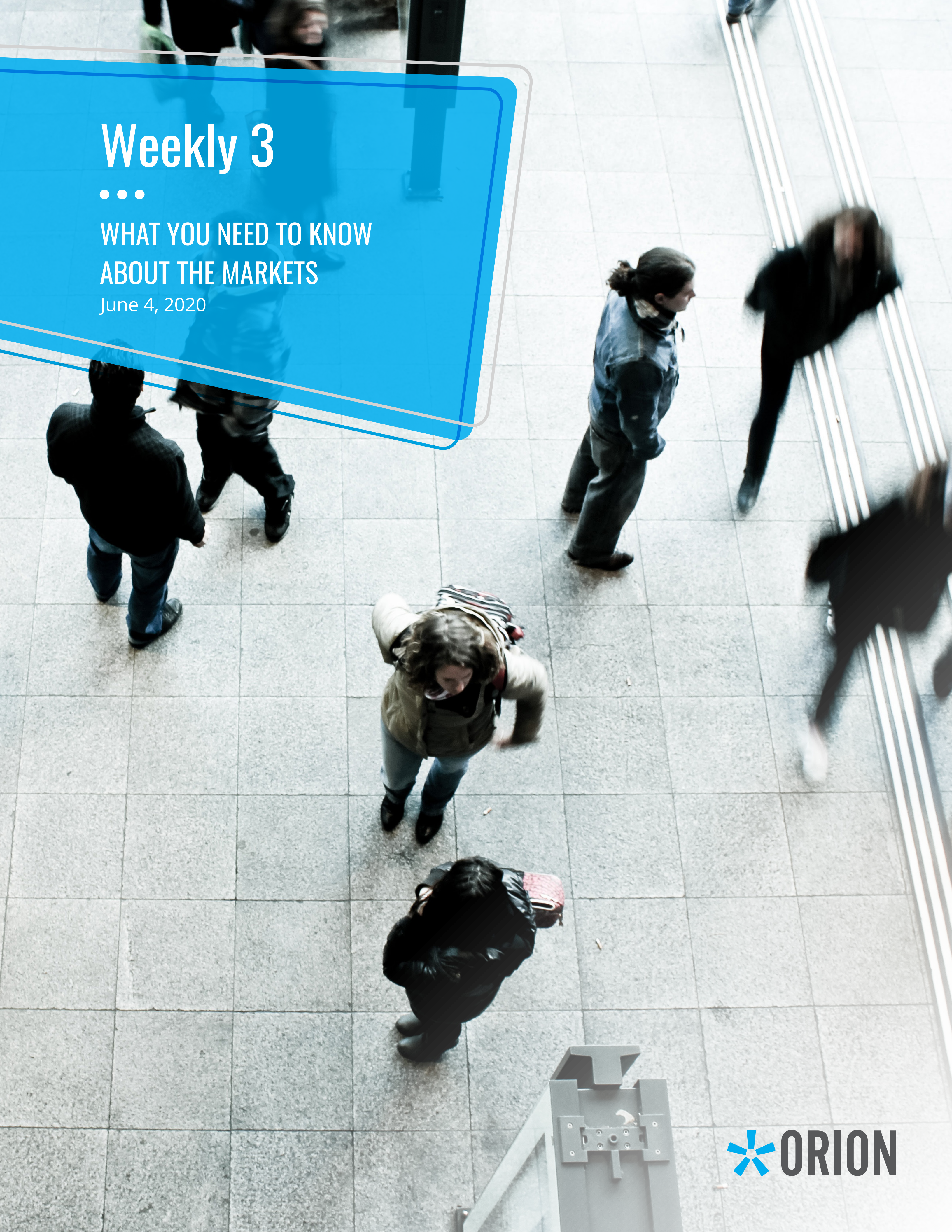
Weekly 3

WHAT YOU NEED TO KNOW ABOUT THE MARKETS

June 4, 2020



ORION

Wall of Worry | Key Factor for Investment Alpha | Starting Points Matter

By Rusty Vanneman, CFA, CMT
June 2020

- Despite another good month, the Wall of Worry remains intact.
  - We belive investors can expect more extreme volatility, including the possibility of additional sharp gains before year-end.
- Managing expectations is key to attaining investment alpha*.
  - Establishing common definitions can help to keep advisors and investors on the same page.
- Has value investing finally turned the corner?
  - Value stocks have never been cheaper.

Market Performance

as of 05/31/2020

FIXED INCOME	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	0.58	1.12	1.68	1.56	0.42	0.01	0.01
U.S. Investment Grade Bonds[2]	3.92	3.94	5.07	9.42	5.47	2.25	0.47
EQUITIES	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	8.60	5.29	5.13	5.19	-9.28	15.77	4.58
Total U.S. Market[4]	12.97	9.38	9.82	11.92	-5.24	19.29	5.37
Domestic Large-Cap Equity[5]	13.57	10.69	11.55	15.87	-2.89	18.22	4.68
Domestic Small-Cap Equity[6]	9.41	3.29	1.50	-4.17	-16.15	22.60	6.98
International Equity[7]	4.72	1.11	0.03	-2.96	-14.59	11.91	3.79
Developed International Equity[8]	5.22	1.08	0.03	-2.41	-14.06	12.18	4.62
Emerging Market Equity[9]	3.04	1.22	0.22	-4.53	-16.12	11.13	1.45
DIVERSIFIERS	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	2.04	-0.90	-1.68	-4.69	-8.94	5.66	0.62
Commodity[11]	-6.00	-7.79	-6.90	-17.06	-21.20	2.74	4.34
Global Real Estate[12]	6.47	1.24	-0.18	-11.06	-19.08	9.37	1.32

Source: Morningstar

[1]Morningstar Cash Index [2]Bloomberg Barclay's Capital U.S. Aggregate Bond Index [3]Morningstar Global Market Large-Mid Index [4]Morningstar U.S. Market Index [5]Morningstar U.S. Large Cap Index [6]Morningstar U.S. Small Cap Index [7]Morningstar Gbl ex U.S. Large-Mid Index [8]Morningstar DM ex U.S. Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversified Alternatives Index [11]Bloomberg Commodity Index [12]Morningstar Global Real Estate.

The Weighing Machine podcast is on Google Play and iTunes.

On Orion Portfolio Solutions' The Weighing Machine podcast, Rusty Vanneman and Robyn Murray cut through the market clamor and focus on time-tested, proven principles that help financial advisors and investors reach their long-term financial goals.

Market Update Video

* *Alpha is defined as the excess return on an investment relative to the return on a benchmark index.*

May Market Review

Our society, economy, and markets are currently in turmoil. This too shall pass.

While there is much to consider and reflect on during these tumultuous times, within this investment commentary we will attempt to hold our focus on what the markets are doing and how advisors and investors should consider adjusting their portfolios.

For investors, it's clear that everything is moving much faster than it was before. There are reasons for this, including faster media/information, technology, and arguably shorter attention spans. Market structure (i.e., the way most securities are traded) can also cause market movements to be more violent. Investors should expect this to continue, while building and maintaining diversified portfolios to weather these market movements.

After one of the fastest market corrections (loss of 10%+) and bear markets (loss of 20%+) in U.S. market history, we are now experiencing one of the sharpest market rallies, which created the shortest bear market in U.S. market history (out of 37 bear markets since 1900).

After years of below-average price volatility, we are now in a new volatility regime, which is just a fancy way of saying we should all expect higher-than-usual volatility to persist. Investors should be prepared for such and invest accordingly.

For long-term investors, this backdrop may suggest a wide range of potential market outcomes in the months ahead, including the very real potential to achieve new highs (more likely), or to retest the March lows (less likely but clearly possible). Staying balanced and diversified in a portfolio with an appropriate level of risk remains as prudent as ever.

Since the market bottom, the broad U.S. market indices, as measured by the Rusell 3000, are up nearly 40%, investors are approximately $9 trillion wealthier and the U.S. stock market is now down less than 5% year-to-date and up nearly 10% over the last year. Sounds pretty good, doesn't it? However, these numbers hide the turmoil and mask some of the sharp performance differentials we've experienced (just look at the performance table above).

Good arguments can be made for prices to climb substantially higher. Good arguments can also be made for prices to fall substantially lower. Ultimately, that's just a good argument to remain humble and diversified. Let's dive into some of those reasons.

RUSTY VANNEMAN, CFA, CMT
Chief Investment Officer

Rusty Vanneman serves as Chief Investment Officer (CIO) for Orion Advisor Solutions, where he is responsible for overseeing the investment processes across Orion and its subsidiaries, including CLS Investments.

*Mr. Vanneman joined CLS in September 2012 as CIO. Previously, he served as CIO and Portfolio Manager at Kobren Insight Management (KIM) in the greater Boston area. His 11-year tenure at KIM included a 5-year span during which the firm was owned by E*TRADE Financial and he served as the Senior Market Strategist for E*TRADE Capital. Prior to working at KIM, he was a Senior Analyst at Fidelity Management and Research (FMR Co) in Boston. He was also a Managing Analyst at Thomson Financial. In 2018, Mr. Vanneman took on the role of President of CLS, in addition to his position as CIO. He became CIO of Orion in 2019.*

*Mr. Vanneman received a Bachelor of Science degree in Management from Babson College where he graduated with high distinction. He has held the Chartered Financial Analyst® designation since 1994, and is a member of the CFA Institute. He has also been a Chartered Market Technician® since 1999, and is a member of the Market Technician's Association (MTA). In addition, Mr. Vanneman authored the book "Higher Calling: A Guide to Helping Investors Achieve Their Goals." He was named one of the Top 10 Portfolio Managers to Watch by Money Management Executive in 2017.**

**Rusty Vanneman, CFA, CMT, was selected as a "Top 10 Fund Managers to Watch" in 2017 by Money Management Executive. Money Management Executive is an unbiased, third-party publication covering the asset management industry. Money Management Executive chose the list of managers to watch by screening Morningstar data from funds with a single manager, ranked as having the best three-year annualized returns in their respective categories. The list of managers was published March 27, 2017. Money Management Executive is not affiliated with CLS. Ratings and awards may not be representative of any one client's experience and are not indicative of CLS's future performance.*

Market Outlook: Prices Climb Wall of Worry

1

For investors, there are many supportive factors that suggest the possibility of additional gains and others that point to potential losses.

Positive Factors:

On the positive side, at least for now, there is the reopening of the economy. This creates undeniably positive social and economic momentum. This isn't difficult to do, however, since over the past several months the economy has arguably been the poorest it's ever been in U.S. history.

Markets tend to move on trends, not levels. In other words, when things get "less bad," prices usually improve. It's all about investors adapting to changing expectations. If people expect the worst, but things marginally improve, prices will typically reverse, and vice versa (something to keep in mind for FANG (Facebook, Amazon, Netflix, and Alphabet) stock fans).

Despite being a common refrain, the idea that "we have never been here before", isn't true from a societal standpoint. We have written about various pandemics before, including what I believe is the most relevant template for our current situation: the 1957 flu. At this point, the 1957 flu was arguably worse than COVID-19, and the economy and markets moved in a similar fashion as they have recently. Markets, which anticipate what may happen in the economy, tend to lead the official economic data, which is based upon collected information from the past.

For a quick refresher on the 1957 flu, it hit the U.S. in the summer. The stock market sold off immediately and didn't stabilize until the fourth quarter. Economic growth was still positive in the second and third quarters of 1957, but was down sharply in the fourth quarter and down 10% in the first quarter of 1958 (the worst quarter for economic growth since WWII — until perhaps when this current quarter ends, of course). Prices bottomed in the fourth quarter of 1957 and then proceeded to gain more than 40% in 1958 and didn't have a losing year until 1962.

What's different with this pandemic? Again, everything is moving faster. For better or worse, it's been said that this was the first "social media panic." Information moved faster. Fear and caution were elevated more quickly. This surely saved lives and also activated unprecedented global collaboration for the development of treatments and vaccines. It should provide some reassurance to investors given the talent, resources, and urgency devoted to the cause. As a betting man, I'm taking the under on treatments and potential vaccines being developed faster than they have in the past.

Perhaps the biggest reason to be positive remains the investing principle: "Don't fight the Fed." We have seen unprecedented monetary support from the Federal Reserve, including pinning short-term interest rates at 0% for the foreseeable future, injecting massive amounts of liquidity into the system, buying ETFs (including corporate bond ETFs), and moving markets with the sheer power of its symbolic words and actions. The Fed is doing more than just protecting the financial system; it's also providing massive, unprecedented support to help ensure the markets don't crumble. Though the wisdom of the support may be debatable, and there will be a price to be paid; for now, it's serving as a positive for the markets and provides a tidal wave of liquidity that investors should respect.

1

For the economy, at least in the short-term, the fiscal support has been the strongest since WWII. Federal spending as a percentage of GDP has averaged 20-25% for decades. Investors can expect that number to double this year. Europe and Japan have also provided massive fiscal support. That's a lot of 'juice' in the system.

"Don't fight the tape" is also a powerful principle. There is a lot of technical (based on the study of prices) support for more gains, including good market breadth (which indicates that most stocks are participating in gains, not just a handful of glamour stocks). Healthy markets typically have broad participation, and now this market does as well.

It should also be noted that sectors which were hit hard, have also bounced hard. For example, energy prices as measured by OK Crude Oil Future Contracts were up over 80% last month (best month ever), and energy stocks were up nearly 53% as measured by the Energy Select Sector SPDR ETF. Again, an example of how prices typically lead economic activity.

Lastly, investor sentiment, both individual and professional, remains extremely negative, which is simply remarkable given the gains off the lows already. The Wall of Worry is still firmly in place. Typically, when sentiment is this negative, the stock market produces above-average gains for the next one-, three-, six-, and 12-month periods. Sentiment is cyclical and works as a contrarian signal because markets are always adapting to changes in expectations.

Negative Factors:

Granted, there are also plenty of not-so-good factors.

- **COVID-19:** We will undoubtedly see a second (and perhaps a third) wave of infections. How manageable will that be? While it doesn't seem likely now, a second national lockdown would be devasting in many ways.
- **Social unrest:** How much of an impact will the current civil unrest have, at least in terms of the economy and markets? It's clearly not good and will only get worse the longer it occurs. As for how the markets have responded during past civil unrest (such as 1992 in the U.S. or in 2011 in England), the markets generally seem to side on the view that order will eventually be restored.
- **Tension with China:** This is a big deal, though obviously other issues have dominated front pages. There also seems to be some investor fatigue over the issue. The most probable near-term result will likely be more volatility. This issue also has the potential to negatively impact corporate profitability. Less globalization may also lead to higher inflation.
- **Inflation:** While the official numbers are low and falling due to demand shock, consumer expectations of inflation are not (grocery items costing substantially more will do that). There are plenty of reasons inflation may move higher later this year, including supply disruptions, higher wages, exploding federal deficits, and more.

- **Political season:** Politics typically create market volatility, and it's reasonable to expect that the societal pressures occurring now will negatively impact the markets more than ever.
- **Social media:** Social media giants Facebook and Twitter also face political risk. The market has been led by these types of high-profile, large companies in recent years. When the dot.com bubble burst two decades ago, the glamor stocks' fall led the market down. It should be noted, however, that broadly diversified global portfolios held up much better during that time.
- **Summer doldrums:** The summer is typically the weakest time of year for the market, without much direction. It's hard to imagine that this summer will be quiet though.
- **Overbuying:** The market is "overbought" from a technical standpoint, which would suggest a pause to refresh. That said, when market prices look overextended, investor sentiment is typically giddy. That is not the case now.
- **Valuations:** The market is expensive. High valuations suggest lower expected long-term returns and a higher probability of short-term losses. The offset to this concern is that the market typically handles higher valuations better when interest rates are low. In this case, the risk may not be the high valuations themselves, but rather the potential for climbing long-term interest rates.

Sneak Peek at Upcoming Risk Changes

2

For years, when people entered our headquarters in Omaha, they could see, printed on the back wall in bright lights, the primary goal of our organization: “Empower Advisors.” Our mission has always been to help advisors attain their definition of success, which, of course, includes investors achieving their long-term goals. We still strive to achieve our goal each day.

Over the years, we have accomplished this in a few ways, which have included helping to provide “operational alpha,” “advisor alpha,” and “investment alpha.” Let me explain.

Operational alpha: This refers to Orion technology, which provides enhanced efficiency and effectiveness for advisors in running their businesses and helping their clients.

Advisor alpha: This refers to the amount that advisors help investors outside of just raw investment results. This advisor alpha has been defined by various firms, such as Vanguard, Russell, and Morningstar. It is usually quantified as 3%+ per year. Advisor alpha comes from a variety of activities, including appropriate risk assessment and asset allocation, tax management, rebalancing, managing expectations, and much more.

Investment alpha: Investing is not about beating the markets; it is about beating the bank. That’s why investors put their money in the stock market instead of their checking accounts. Investment alpha is basically the “equity risk premium,” which refers to the fact that stocks have historically beat cash by approximately 5% per year (it’s actually been more than that in every current lookback period, including, remarkably, the one-year)[*].

As advisors, we want clients (once they have their near-term safety nets established and short-term liabilities budgeted) to be able to invest in the stock market at whatever level is appropriate for their goals, risk tolerances, and other unique considerations.

The way we can help investors to partake in investment alpha is to build diversified portfolios, commensurate with their needs, and provide the support that goes with them. We help attain investment alpha not only through the way we manage money, but also through managing expectations and emotions through our various communications, thought leadership, and client service.

That last sentence is key. We’re not just managing portfolios; we also help manage expectations and emotions regarding the markets. A key part of managing expectations is making sure common definitions and terms are being used.

Last fall, the major divisions of Orion came together to function in seamless collaboration. There were several good reasons for this, including increased synergy and resources for all parties involved. The various Orion companies that joined together were Orion Technology, Advizr (financial planning), FTJ Fund Choice now Orion Portfolio Solutions, and CLS Investments.

As the Chief Investment Officer of Orion, I quickly noticed that each company defined risk in different ways. The way we labelled it, the way we risk-scored investors, and the way we risk-scored investments were not the same. Each way worked, of course, but they were different. I felt it was important to make sure everybody in Orion was talking about risk the same way.

* *Investopedia https://www.investopedia.com/terms/e/equityriskpremium.asp#:~:text=Equity%20risk%20premium%20refers%20to,higher%20risk%20of%20equity%20investing*

Introducing common definitions was also an opportunity to enhance the process (thanks to advisor feedback) behind the risk-scoring. These changes will be introduced later in June. We will be updating our websites and providing fresh materials to accompany the change.

It is important to note that this is not a change in philosophy. We still believe in balanced portfolios. Not just diversification by asset class, but also by strategy. We still believe portfolios should have exposure to strategies designed to capture movement of the markets. We also believe investors should have strategies that are able to adjust for changing market conditions through active management. And we believe investors should have some level of strategies designed to disengage from market movement and provide new sources of potential return and risk. That level depends, of course, on their objectives and risk tolerance.

In sum, clear definitions shared by both advisors and investors should help in understanding and explaining how markets and portfolios behave over time. This understanding will go a long way in establishing proper expectations.

Starting Points Matter in Investing

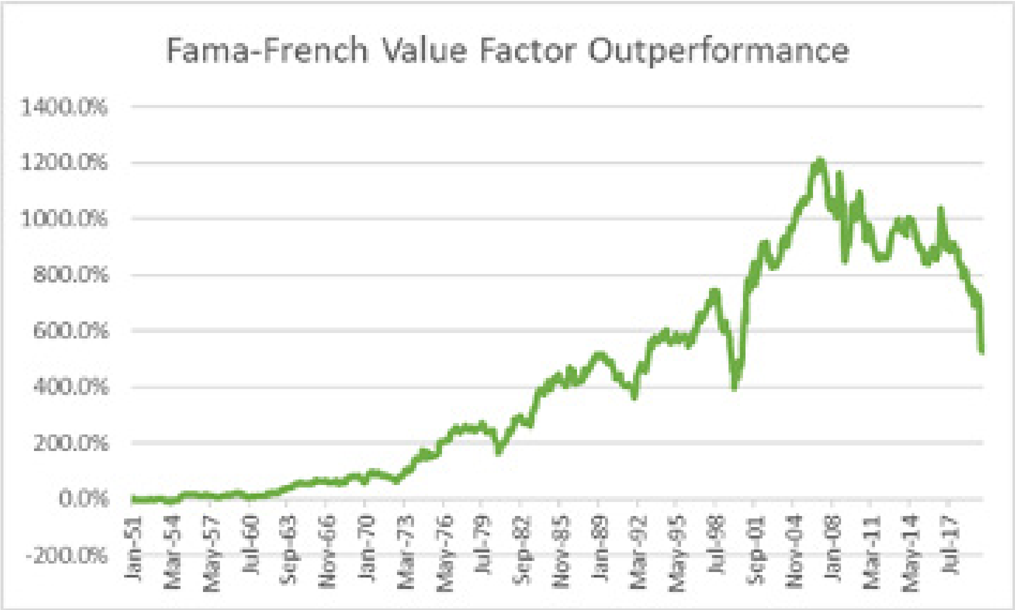
3

We have written a lot about value investing in these commentaries. From a long-term perspective, building a diversified portfolio and buying securities on sale (or, perhaps more importantly, not buying securities that are extremely expensive) has been a prudent way to build portfolios.

At minimum, just regularly rebalancing portfolios, a process that involves buying securities that have underperformed and selling securities that have outperformed, to get back to a strategic allocation has historically been an effective way to help enhance risk-adjusted performance. Rebalancing has been effective because it has helped both sides of the risk-adjusted performance equation. It has helped the denominator — risk – by staying at appropriate levels. It has helped the numerator — return — by improving returns. Rebalancing is essentially a value-oriented (as opposed to momentum) activity.

As investment counselors, having a value bent has also been, I believe, a prudent way to talk about and build investment portfolios. It's not only intuitive to buy investments on sale, but the academic literature and actual historical market experience shows the biggest problem that most investors have is not fees, or a lack of intelligence or good investment options; it is chasing performance — buying investments after they have gone up in value and selling them after they have gone down. The losses incurred by this investor activity are typically called the "behavior gap." Quite frankly, taking advantage of this investor behavior is why value-oriented investors tend to win over time.

While value investing has worked over time, it hasn't necessarily worked over the last 10 years, as the chart below shows.



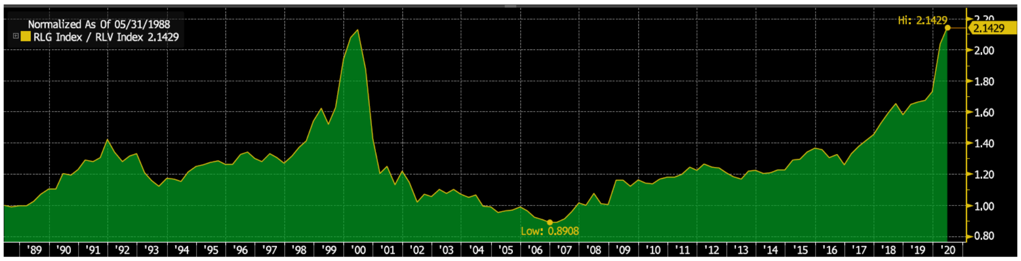
Source: Bloomberg, 06/03/2020

Though the line chart doesn't show vast underperformance, value stocks have underperformed versus growth stocks by nearly 6% per year for a decade.

It should be noted that value stocks have still earned nearly 10% per year for those 10 years, but growth stocks have earned a whopping 16% per year. Even though value investing has beaten growth investing 93% of the time over historical rolling 10-year periods, we are currently experiencing that 7% of the time during which value has underperformed.

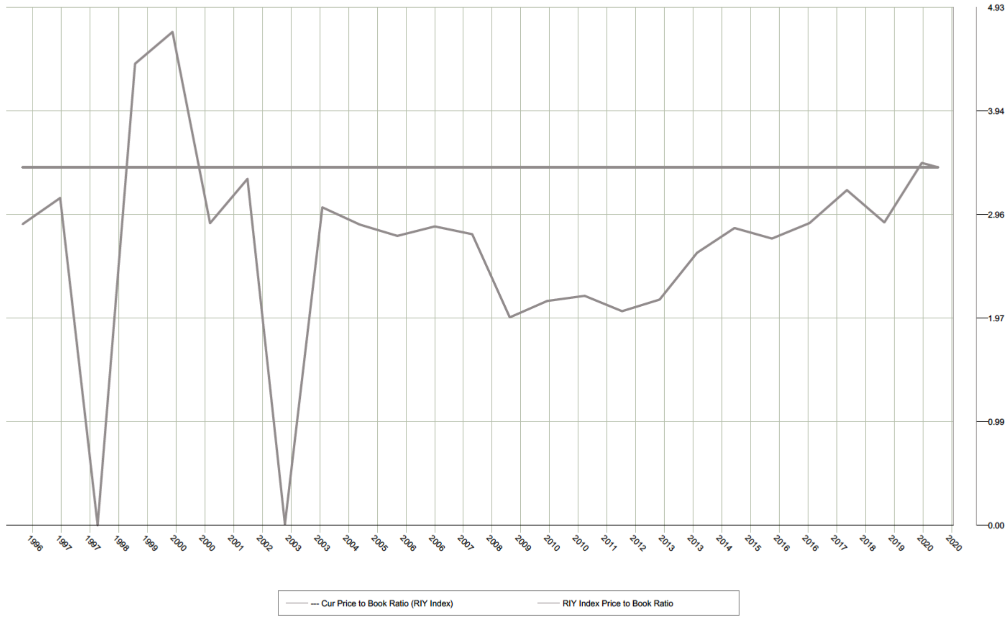
The next chart shows relative performance since 1990. Growth performed well in the 1990s, especially in the late part of the decade, until value was able to earn back all of the relative performance it lost and then some in the years that followed the dot.com bust.

Then *growth* went on its next run, steadily outperforming for years, until it recently went parabolic, hitting the old highs in relative performance in mid-May of this year. It is interesting to note that value has outperformed since — is this finally the beginning of value's next run? If so, old-timers would call this chart a "double top," and it would suggest value will perform relatively well moving forward.



Source: Bloomberg, 06/03/2020

From a valuation standpoint, illustrated below are the historic Price to Book ratios for the Russell 1000. The only time the ratio has been higher is during the Dot.com bubble.



Source: Bloomberg, 06/03/2020

So why hasn't value investing "worked" in recent years?

There are a few notable reasons.

1. **Below-average economic growth:**

   Economic growth has been below average in recent years. Value stocks tend to do better when economic growth is above average as they tend to witness larger increases in earnings and profitability.

2. **Low inflation:**

   Related to low economic growth, value also tends to underperform when inflation has been below average. Value stocks tend to do better when they have some ability to raise prices.

3. **Falling longer-term interest rates:**

   Also related to the factors above, value stocks tend to do better when interest rates are rising. While higher rates don't necessarily help their bottom line, higher long-term rates compared to short-term rates (i.e., steeper yield curve) tend to help the profitability of financial stocks, a key sector within the value universe.

And there are more reasons:

- While value investing has still worked (up 10% per year for last 10 years), growth/glamor stocks have done even better.
- Value has been a bet against technology.
- One key definition of value is the price/book ratio. But book value doesn't capture the full value of many companies anymore due to the relatively large amount of intellectual capital compared to physical assets now on balance sheets. Nonetheless, even if one adjusts by using different valuation measures, such as price/sales or price/cash flows, it's still the same story — value has underperformed.

Jack Forehand from Validea Capital recently explained why value hasn't been working and why it should work again. First, let's look at a few reasons Forehand thinks value has not been working.[*]

1. **The World is Different**

   The Federal Reserve and other central banks have changed the game by engaging in large-scale asset purchases. They have encouraged risk taking without the consideration of fundamentals.

2. **Too Many People Are Doing It**

   In investing, whenever anything works, more and more people follow it. Since the publication of Fama and French's three factor model, that is exactly what has happened with value. That has the potential to degrade or eliminate the value premium.

3. **The Capital Following it is Becoming More Permanent**

   Followers of value strategies want other value investors to panic during periods of underperformance. That bad behavior is in part what makes it work. Permanent followers of the strategy who won't panic no matter how long it underperforms can reduce its effectiveness over time.

Given these considerations, why should investors continue to invest in value stocks?

Besides the reasons cited above, including accelerating growth, inflation, and interest rates, which all seem probable coming out of this recession, let's revisit Jack Forehand to read it in his words.*

3

1. **Value Stocks Are as Cheap as They Have Ever Been**

   No matter how you look at it (even if you control for market cap or sector or region), value stocks are at or near the cheapest they have been in history on a relative basis.

2. **Reasons Value Works Still Hold**

   One of the major reasons value investing works is because investors tend to systematically overestimate problems.

   The second reason that value works is because it is riskier, and historically investors have been compensated for that risk.

3. **This Has Happened Before**

   The period most of us remember the best is the late 90s, where many called value dead. Those of us who believe in value can only hope this period will end with the kind of relative outperformance that one did.

In sum, buying investments when they are on sale at attractive prices remains a prudent way to build and manage diversified portfolios, especially when the sales prices are this attractive.

Thank You

Thank you for your time and trust in these turbulent times. If you have any questions or feedback, please let me know. Stay balanced, stay the course, and please be well.

RUSTY VANNEMAN, CFA, CMT
Orion Advisor Solutions
Chief Investment Officer
Rusty@Orion.com
402-896-7641

* *Jack Forehand, The Case Against Value:* http://blog.validea.com/the-case-for-value-stocks/

The Morningstar Global Market Large-Mid Index is an index that measures the performance of the global market's equity markets targeting the top 90% of stocks by market capitalization. The Morningstar U.S. Market Index is an index that measures the performance of U.S. securities and targets 97% market capitalization coverage of the investable universe. It is a diversified broad market index. The Morningstar U.S. Large Cap Index is an index that measures the performance of U.S. large-cap stocks. These stocks represent the largest 70% capitalization of the investable universe. The Morningstar U.S. Small Cap Index is an index that measures the performance of U.S. small-cap stocks. These stocks fall between the 90th and 97th percentile in market capitalization of the investable universe. In aggregate, the Small Cap Index represents 7% of the investable universe. Morningstar Global ex U.S. Large-Mid Index is an index that measures the performance of Global Markets (ex-U.S.) equity markets targeting the top 90% of stocks by market capitalization. The Morningstar DM ex U.S. Large-Mid Index is an index that measures the performance of developed markets ex-U.S. equity markets targeting the top 90% of stocks by market capitalization. The Morningstar EM Large-Mid Index is an index that measures the performance of emerging markets targeting the top 90% of stocks by market capitalization. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Morningstar Cash Index is an index that measures the performance of a Treasury Bill with six to eight weeks until maturity in the U.S. market. The Morningstar Diversified Alternatives Index allocates among a comprehensive set of alternative underlying ETFs that employ alternative and non-traditional strategies such as long/short, market neutral, managed futures, hedge fund replication, private equity, infrastructure or inflation-related investments. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. This index provides investors with a means of understanding the performance of commodity futures markets and serves as a benchmark for investment performance of commodities as an asset class. The S&P 500 Index is an unmanaged index of 500 large-capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The volatility of the indexes may be materially different from the individual performance attained by a specific investor. In addition, portfolio holdings of investors may differ significantly from the securities that comprise the indexes. You cannot invest directly in an index.

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Contact Us Today

17605 Wright Street | Omaha, NE 68130

402.895.1600 | orion.com

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